

# E.Q Trendwatch™

## Not everyone is holding toxic waste

We have received a lot of press recently over the fact that our clients have had no US dollar based investments for the past year, and we have not had any exposure to the toxic waste debt products like Asset Back Commercial Paper (ABCP), CDO's, CPO's, etc. The list of sub-prime mortgage levered paper out there is seemingly endless.

Over the past few weeks we have been featured in several articles in The Star, The Post, and a few national magazines. Reporters all have been asking the same question: why have we not lost money with the mass of other Canadian investors this year? We would love to say it's 'cause we're brilliant. But that would be too generous. In our view, it's really more about being careful, doing homework and investing money as if we have something to lose—*like hard-earned capital!* No matter what many market participants have come to believe, *gambling is not an investment strategy.*

The explanation goes back to the fundamental approach that makes our service unique in the marketplace. We do not slap on blind asset-allocation-rules-of-thumb about how much of our client capital should be invested in any particular currency, country, sector or class. For us, all allocation and investment timing decisions are actively made on an objective assessment of their risk and reward probabilities.

When the US dollar broke down technically many months ago probabilities suggested that the risks of further deterioration in the greenback were significant and mounting. So we got out. Our discipline takes the risk measurements every day to determine whether an asset's promise of reward justifies the risk of holding it.



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When the masses were fed up with 50-year lows in interest rates the “industry” started selling “ingenius”, high yielding asset-backed paper, and other genetically altered fixed income. We steered clear and kept our holdings in the boring old tried and true. Now unsuspecting investors, as well as managers who ought to have known better, have discovered that they have large weights of their portfolios in “bond-like” paper that is now frozen or trading for pennies on the dollar. Recently we saw the chief economist from CIBC telling a luncheon audience about the losses in sub-prime based “bonds”, and explaining, that “everybody holds this paper. Everybody. It’s everywhere.” Well, perhaps everywhere, but in our client accounts, would be an accurate statement.

And so the cover-their-butt letters from the brokerages have been sent out once again by their lawyers, as the underwriters claim shock and surprise at the problems in the debt markets. The only problem is they were the masterful architects of this disaster in the first place. It was the genius of the underwriting and packaging of toxic debt into magical AAA tranches that caused the present trauma, and the brokerage houses and investment banks made billions selling this garbage. Now they will have to eat some of their own poison and write down billions of losses. But the little people who are left holding the toxic waste will suffer the most once again.

Recently prospective clients have been showing us their statements, asking us for a second opinion as to why their accounts have lost 10-40% of their value over the past 12 months. It is hard to appreciate the losses that others have incurred when they are not happening in our own accounts. If we are just watching the financial quotes on the news each day it might seem that markets have all been doing great this year. The reality is that most Canadian investors do not get index returns and have actually lost money on their aggregate portfolios over the last 10 months thanks to foreign currency losses and compromised debt markets.

Probabilities of lasting rewards from these levels still do not favour the Bulls.

We have still not had even a 10% correction in North American broad market indices for over 5 years! Each time a healthy correction has gotten under way, speculative and levered capital has jumped back in to “buy the dips”. When valuations are as over-stretched as presently, buying the dips is like jumping to pay 30% more than fair value this week, because last week the same thing would have cost 35% more than it is worth! Valuations that drop from dumb to silly are still not attractive to a thinking person. But as we know, a whole host of market participants are not thinking, they are feeling. They are reacting, hoping, chasing, following—everything, anything, but critical thinking.

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One of the most persistent truths in human history is that stretching for extra investment yield usually leads to capital losses. This is why the most successful investors in the world patiently wait until valuations come back to fair value, and below fair value, before they will buy. As Peter Bernstein reminded in a recent article, the rational response when valuations are over-priced is to withdraw until valuations become more attractive.

## US Housing: the main economic story continues...

The below chart tells quite a story of house prices and why the housing correction will be on-going for some time to come. In a word: even though prices have been falling for the past year, they are still way, way above mean.



Optimistic reports that the economy will avoid a major slow-down from housing problems, quote assumptions of a modest 2-5% drop in housing prices from here. But clearly at this point, regression to the mean would require a greater drop. In order for home prices to revert to their normal alignment with rental housing, Robert Shiller of the Case-Shiller index has warned that home prices

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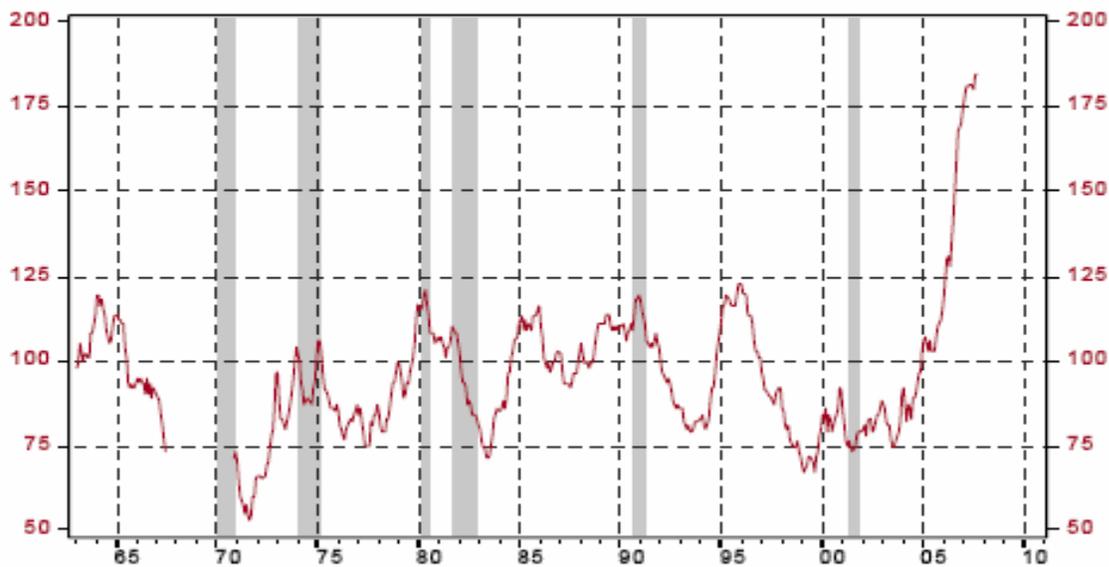
would need to fall, on average, 50% (this has already happened in some areas of California). On more conservative measures, home prices would need to fall a further 20% to bring affordability back to semi-normal levels.

Whether it is 10, 20 or 50% that prices correct from here, the losses will be painful for property owners who have bought on spec over the past couple of years, and for the economy in general. For those that bought houses on spec, with leverage, this price correction is likely to be financially fatal, albeit highly predictable as a natural part of this bubble busting.

The next chart gives us some long term perspective (1960 to 2007) on the number of US homes which are now completed and sitting empty waiting for buyers. The answer: just about twice as many units than ever before!

### New 1-Family Houses For Sale: Completed Units

NSA, Thous



Source: Census Bureau /Haver Analytics

And builders are still building. Also, there are now \$800 billion of adjustable rate mortgages due to reset to much higher rates over the next 12 months. Defaults on these mortgages are likely to be high since they are homeowners with significant negative equity who will be most likely to turn their keys over to their lenders and walk away. Many of these homes are expected to come back on the market through foreclosure. All of these trends will inevitably add more supply to an already deluged market. Again, this will be a normal, although aggravated end, to this overheated cycle.

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We know that the homebuilding companies have had their profits decimated, with the National Association of Home Builders (NAHB) Index now down more than 70% from its 2006 high. We know that in the last downturn the NAHB Index led the S&P 500 stock index down with a lag of about 1 year. Since the NAHB peaked in the first quarter of 2006, the suggestion of correction in the S&P 500 is now ominous as shown in the chart below:



Source: FactSet, as of Aug. 31, 2006. NAHB represents the National Association of Home Builders.

Six of the past 8 housing recessions have ended up in an economy-wide recession and we know that this housing recession is shaping up to be the worst in over 70 years.

Recall that a year or even 6 months ago, the bulk of mainstream commentators said that none of this was likely or serious. Recently many have been starting to sound the alarm:

*“We think a miracle is needed to avoid a recession. With domestic demand growth struggling to stay above a 1% run-rate, if we manage to avoid a recession with another huge down-leg in homebuilding activity and home prices, we think it will be a miracle.”*

*–David Rosenberg, Merrill Lynch, Chief US Economist*

**Bottom line:** As soon as markets have acknowledged and re-priced for these risks, some once-in-a-decade opportunities are likely to present for us with lower priced and higher yielding assets across the board.

Remember you can visit our blog: [www.jugglingdynamite.com](http://www.jugglingdynamite.com) for weekly commentary.

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